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UNITED STATES SUPREME COURT

OCTOBER TERM 1981

V.P. DIEDRICH and
FRANCES T. DIEDRICH, and

UNITED MISSOURI BANK OF KANSAS CITY,
N.A., EXECUTOR OF THE ESTATE OF
FRANCES D. GRANT,

Appellants,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Writ of Certiorari From
The United States Court of Appeals
For The Eighth Circuit

BRIEF FOR LAIRD C. CLEAVER AND KAREN K. CLEAVER AS AMICUS CURIAE

Joseph C. Niebler, Counsel of Record
Lynn M. Meidam
Miller and Niebler S.C.
611 North Broadway Street
Suite 500
Milwaukee, Wisconsin 53202

Phone: (414) 271-2700

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SUMMARY OF ARGUMENT

The first argument presented by amicus curiae is based on the framework of the Internal Revenue Code (IRC). Congress structured the IRC to provide separate taxes for separate transactions, the income tax, the gift tax and the estate tax. An example of this Congressional intent can be found in sec. 1015 and sec. 2501 of the IRC and the treasury regulations thereunder. The gift tax consequences occur at the time of transfer when the gift tax is levied. The income tax consequences occur at the time the donee disposes of the property using the basis determined under sec. 1015 IRC to compute the taxable gain to the donee. The transfer before this Court is a gift transfer and the only applicable IRC sections are sec. 2001 and sec. 2501.

In Part C of the Argument, amicus curiae contends that while the donor is liable for the gift tax under sec. 2502(d) IRC, the IRC also provides that if the gift tax is not paid when due the donee becomes personally

liable for the gift tax to the extent of the value of the gift under sec. 6324(b) IRC. Thus, payment of the gift tax also has an economic benefit to the donee who upon payment of the tax is assured that the lien imposed by sec. 6324(b) IRC is extinguished. This payment of the gift tax liability, imposed by operation of law, is thus not the release of liability taxable under the Crane doctrine.

The third argument of the amicus curiae is based on Congressional inaction regarding the net gift income tax issue. For eight years prior to the enactment of the Tax Reform Act of 1976, Congress was aware of the part gift, part sale theory promulgated by the Commissioner of Internal Revenue (Commisioner) and of the rejection of such theory by the Tax Court, and the Fourth, Fifth and Sixth Circuit. Congress however did not legislate a result contrary to the impressive precedent. Legislation is to be construed in terms of judicial precedent in existence at the time of the enactment and when such precedent is not corrected, approval of it

must be assumed.

The final argument presented involves the reliance by taxpayers on legal precedent. In order to promote intelligent tax planning, taxpayers must be able to rely on the legal precedents existing at the time they are making a decision. In this case legal precedent existing at the time the gifts were made included IRC provisions and treasury regulations which provided separate taxes for disposition of property by gift and by sale. Revenue Rulings regarding net gifts failed to state the Commissioner's position regarding income tax consequences of a part gift, part sale. In addition over eight years of case law rejected the Commissioner's position. After all these years of legal precedent, it is too late to change the law for taxpayers who relied on years of legal precedent for guidance in their tax planning.

I. INTEREST OF AMICUS CURIAE

The amicus curiae, Laird C. Cleaver and Karen K. Cleaver, his wife (herein "Cleavers"), pursuant to the spousal gift splitting provisions set forth at sec. 2513 IRS, on December 17, 1976, gifted $1,895,312.50 worth of highly appreciated stock, to an irrevocable trust established for the benefit of Mr. Cleaver's issue on the express condition that the trustees pay any gift taxes imposed on the transfer. In 1977, the trustees paid federal gift taxes of $357,563.75 and state gift taxes of $158,218.60, for a total of $515,782.25. The trustees raised the dollars to pay the tax by borrowing from a third party.

The Internal Revenue Service (IRS) issued its notice of deficiency to the Cleavers on May 13, 1981, for income tax deficiencies for calendar year 1976 claiming additional income taxes due of $178,866.00 relating to the gift; the IRS claims the income tax on the basis that the gift was a part sale and the Cleavers recognized taxable gain equal to the

difference between the basis in the property transferred and the gift taxes paid. The issue is presently pending in the United States Tax Court, Docket No. 10959-81. The IRS issued an additional deficiency notice for the same event for calendar year 1977, and the Cleavers will shortly file their petition in the Tax Court for that year.

The issues presented in the subject case are identical to those faced by the Cleavers, and the Cleavers desire to advise the Court of their interest and position.

II. ARGUMENT

A. INTRODUCTION AND CASE LAW HISTORY

In the case at bar, the IRS seeks to impose an income tax consequence on a gift transaction. The IRS argues that since the gift was conditioned upon the donee paying the gift tax, it is in reality a part sale. The IRS contends that because sec. 2502(d) IRC places the liability to pay the gift tax upon the donor, and the donor is relieved of that liability by the donee's agreement to pay the

gift tax, the donor has been relieved of a liability, and accordingly the donor realizes gain to the extent that the value of the release of that liability exceeds his basis under the principles of Crane v. Commissioner, 331 U.S. 1 (1947) and Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929).

The amicus curiae submits the IRS is incorrect in its position for several reasons. Firstly, Congress has explicitly stated the income tax consequences for gift transactions and established two separate coordinated taxes depending upon the nature of the transfer of property, thereby precluding the IRS from creating fictions to impose dual taxes upon the same event of transfer.

Secondly, the release of liability of the donor imposed by sec. 2502(d) IRC, relied upon so heavily by the IRS to trigger the gain, is not solely the liability of the donor. Under sec. 6324(b) IRC, a lien exists against the property gifted until the gift tax is paid, and the donee is personally liable to the extent of the value of the property gifted if

the tax is not paid when due.

Thirdly, in passing the Tax Reform Act of 1976, Congress specifically addressed the income tax consequences for gifting highly appreciated property to irrevocable trusts without overruling the longstanding case law precedent rejecting the IRS's part gift, part sale argument, thereby adopting the same.

Fourthly, longstanding precedent existed in the Fourth, Fifth and Sixth Circuit Courts of Appeal as well as the Tax Court protecting the taxpayers involved in the case at bar from the income tax consequences sought to be imposed by the IRS, and any change in those tax consequences should be applied prospectively only.

Each of these arguments will be developed seriatim below. However, since the case law history of the IRS's attempts to impose income tax consequences on gift transactions is relevant to all of these arguments, it is set forth at this point in the brief.

The Service first attempted to impose an income tax consequence to a gift to a trust

based on the argument the donor-grantor reserved a portion of the trust income for the purposes of paying the gift tax liability. One of the first cases to address this issue was Estate of A. E. Staley, Sr. 47 B.T.A. 260 (1942) aff'd 136 F.2d 368 (5th Cir. 1943). cert. den. 320 U.S. 786 (1943). In Staley the taxpayer-donor gave $2,000,000 worth of stock to a trust in return for the trustee's promise to pay the first $150,000 of trust income to the donor. The Board of Tax Appeals held and the Fifth Circuit affirmed that the $150,000 was taxable income to the donor based on the reasoning that the donor's intent was a gift of the entire $2,000,000 with a reserved interest in the first $150,000 of income to help pay the gift tax liability.

The next significant decision in this area was Estate of Craig R. Sheaffer, 37 T.C. 99, aff'd 313 F.2d 738 (8th Cir. 1963) cert. den. 375 U.S. 818 (1953) in which the taxpayer-donor created four separate trusts by transferring 70,000 shares of stock. The trustee of the trusts agreed to assume and pay

all gift taxes relating to the transfer. The trustee paid the tax liability using dividend income from the transferred stock and borrowed funds. The Tax Court found and the Eighth Circuit affirmed that sec. 667 IRC applied. Under sec. 667 IRC, supra, the grantor is treated as the owner of a portion of a trust whose income may be distributed to the grantor. The Courts found that the trust's dividend income was used to pay the gift tax liability and thus, it was taxable income to the donor on the basis that the donor reserved part of her gift to the trust for her own benefit.

The next case to deal with this issue was Estate of Annette S. Morgan, 37 T.C. 981 (1962) aff'd 316 F.2d 238 (6th Cir. 1963) cert. den. 375 U.S. 825 (1963) which involved such factual differences from Staley, supra, and Sheaffer, supra, that the Tax Court and the Sixth Circuit reached an opposite conclusion. In Morgan, supra, a decedent established certain trusts by the transfer of stock. The trust agreement stated that the trustees should

pay the donor's gift tax liability, with the trustees having the discretion to pay such liability by either selling the corpus or borrowing. The trustees borrowed the money needed for the gift tax liability and repaid the loan from income earned by the trust in the years following. The Tax Court concluded that the decedent received no benefit from the fact that the trustees borrowed money to discharge her obligation because she did not retain an interest in the trust and could not recover the trust corpus.

With the Morgan, supra decision came a new sublety in this area in that the repayment by a trust of a loan, (the proceeds of which were used to pay the gift tax liability) out of trust income of a later year does not give rise to taxable income to the donor under sec. 667 IRC, but use by a trust of current income to pay the gift tax liability is taxable income to the donor under sec. 667 IRC.

Because gifts to trusts could now be structured to avoid the income tax consequences of sec. 667, the Commissioner developed a new

theory for the imposition of income tax to a gift situation based on sec. 61 and sec. 1001 IRC, referred to as the part gift, part sale. The Commissioner's first opportunity to present this theory in this context was in Turner v. Commissioner, 49 T.C. 356 (1968) aff'd per curiam 410 F.2d 752 (6th Cir. 1969). Factually, Turner, supra involved a transfer of low basis highly appreciated stock to three individuals and six trusts. Each donee signed a letter agreeing to pay their share of the gift tax. The donees subsequently gave the donor a check for their share of the gift tax liability. The Commissioner argued that the donor's gift of stock to each individual was a part sale, part gift and resulted in taxable capital gain income to the donor equal to the excess of the gift tax paid by the donee over the basis of the stock gifted. The Tax Court rejected the Commissioner's argument and concluded that each transaction was more appropriately characterized as a net gift; a gift of the property less the amount of gift tax due on the transfer. In resolving this issue the Tax Court

reviewed the above cited cases dealing with the income tax consequences of a transfer to a trust subject to an agreement by the transferee to pay the donor's gift tax. The Tax Court then rejected the Commissioner's position that the transaction was part sale, part gift which would result in taxable income to the donor; rather the Tax Court concluded that the transaction should more appropriately be characterized as a net gift; that is, a gift of the property less the amount of gift tax due on the transfer.

The Tax Court in Turner, supra indicated that the critical factor in this type of situation is the substance of the transaction rather than the form. When a donor attaches a condition to a gift transfer, such as the donee paying the gift tax, what the donor intended was a net gift, not a sale. The Tax Court's decision in Turner, supra, was appealed to the Sixth Circuit which affirmed the decision.

Since Turner, supra was decided in 1968, the Tax Court has had ample opportunities to

reverse itself and adopt the Commissioner's position of a part sale, part gift. One such opportunity came in Victor W. Krause, 56 T.C. 1242 (1971) (6th Cir. dismissed appeal 6-27-72) where Mr. Krause donated stock to three trusts and the trustees agreed to pay the gift tax liability. The trustees had the discretion to pay the gift tax liability out of the trust income, sale proceeds of the corpus or borrowed funds. The gift tax was paid with borrowed funds, but after the trust had earned some income. The Tax Court held under sec. 667 IRC the donor was taxable on the trust income . which was avilable to discharge his legal obligation to pay the gift tax; however, he was not taxable on the amount of borrowed funds used to pay the gift tax liability nor the trust income earned after the gift tax liability was paid. The Commissioner's argument that the transaction was a part sale, part gift was again rejected.

The Tax Court again had an opportunity to adopt the Commissioner's part sale, part gift argument in Estate of Kenneth W. Davis,

30 T.C. M. 136 aff'd per curiam 469 F.2d 694 (5th Cir. 1972). Factually, Davis, supra involved a gift of stock to one individual and two trusts with the condition that the donees pay the gift tax liability. At the time of the gift the trusts had sufficient assets to pay the gift tax without receiving dividends on the gifted stock. The Commissioner argued that the donor received taxable income on the three transfers based on the reason that the gift to the individual donee was a part sale, part gift and that the gift to the trusts was a retention of an income interest in the trust in an amount equal to the tax paid. Adhering to the precedent established in Turner, supra, and Krause, supra, the Tax Court concluded that no income was taxable to the donor.

After these failures, the Commissioner finally found a factual situation which lent itself to the part gift, part sale theory. The case was J. W. Johnson v. Commissioner, 59 T.C. 791, aff'd, 495 F.2d 1072 (6th Cir. 1974). Factually, in Johnson, supra, the do-

nor borrowed $200,000 on a non-recourse note, using 50,000 shares of appreciated stock as security. The donor then established an irrevocable trust and transferred the 50,000 shares of stock to the trust which assumed the liability for repayment of the note. The donor subsequently paid the gift tax liability of $150,000 out of loan proceeds and kept the remaining $50,000. The Sixth Circuit found that the donor had realized something of value as a result of this gift, that is, he was relieved of the note which encumbered the stock, and therefore had received a taxable gain.

The acceptance of the Commissioner's position in Johnson, supra, did not lead to the acceptance of the part gift, part sale theory in all situations. This can be illustrated by the Fourth Circuit's opinion in Hirst v. Commissioner, 63 T.C. 307 (1974) aff'd 572 F.2d 427 (4th Cir. 1978) (en banc). Factually, in Hirst, supra, the donor Mrs. Hirst, gifted her interest in three pieces of real estate. The donee agreed to assume the

gift tax liability. The worth of the gifts was determined by reducing the value of the transferred real estate by the amount of the gift tax liability. The Tax Court, following the precedent established by Turner, supra, held that Mrs. Hirst was not liable for income taxes on the transaction. On appeal, the Fourth Circuit affirmed the Tax Court's decision relying heavily on Turner, supra, because of the identical fact situation. The Fourth Circuit further justified its decision in Hirst, supra, by stressing that the transaction was not intended by the parties as a sale; but was intended as an intra familial gift; and further Mrs. Hirst, as the donor, received nothing of value as a result of the transaction.

Since 1976 there have been three reported cases, including the one before the Court, dealing with the income tax consequences of a net gift and all of them except Diedrich, supra have held that the donor shall have no income tax consequences as a result of his gift. Estate of Henry, 69 T.C. 665 (1978) involved a gift of stock to a trust on the

condition the trust pay the gift tax. The Tax Court applied the Turner, supra, line of cases and held the donor did not realize taxable income as a result of the net gift transfer. The second case was John T. Benson v. Commissioner, 37 T.C.M. 1978-231 (1978) in which parents transferred stock to their sons conditioned upon sons' payment of the gift tax. Finding the facts presented to be identical to those presented in Turner, supra, the Tax Court held the donors did not realize taxable gain on the gift transfer.

B. WITH RESPECT TO TRANSFERS OF PROPERTY CONGRESS HAS ENACTED SEPARATE TAXES DEPENDING UPON THE NATURE OF THE TRANSFER AND HAS SPECIFICALLY PRESCRIBED THE RULES FOR INTERACTION OF SUCH TAXES TO AVOID THE IMPOSITION OF BOTH TAXES UPON A SINGLE TRANSFER.

Congress has recognized that property can be transferred by sale or exchange, gift, or death, and has imposed a separate tax upon the transfer depending upon the type of transfer. A sale or exchange of property is taxable as income under secs. 61, 1001, and 1002 IRC. Property transferred by gift or inheritance is

excluded from income tax under sec. 102 IRC, but is taxed respectively under sec. 2501 IRC and sec. 2001 IRC.

With respect to gifts, Congress has specifically mandated how the basis of such property in the hands of the donee is to be calculated for subsequent sales or exchanges subject to income tax. Sec. 1015 IRC specifically provides that for gifts made after Septemter 2, 1958, and on or before December 31, 1976, the basis of property transferred by gift in the hands of the donee is the basis the donor had in the property increased by the gift tax paid. Sec. 1015 does not say increased by the "gift tax paid by the donor", but rather says increased by the "gift tax paid", regardless of who pays it. In short, Congress did not care who paid the gift tax. Indeed, the donee may well be liable for the payment of the gift tax under sec. 6324(b) IRC.

The addition to the donee's basis for the amount of the gift tax paid was added by Congress in 1958. At that time Congress specifically addressed what income tax consequence

the payment of the gift tax had. Instead of saying that there may be an income tax imposed depending upon who pays the tax, Congress said the amount of the gift tax - regardless by whom paid - should have the following income tax consequence: add it to the donee's basis because it is a "cost" for the gift transfer which should be recognized as such upon any subsequent taxable sale or exchange of the property:

> Under present law where property is acquired by gift it is generally considered to have the same basis in the hands of the donee for purposes of computing gain, loss, depreciation, or amortization as it had in the hands of the person who made the gift. Where donated property is subsequently sold at a loss, however, the recognized loss is limited to the excess of the fair market value of the property at the time (when this value is below the basis at that time) it was given to the donee over the amount received.
>
> In general, carrying over the basis of property in the case of gifts is in accord with the general principle followed in determining basis; namely, setting the basis of the property at its "cost". In this case the "cost" is the cost of the property to the donor, adjusted for any subsequent depreciation, etc. However, this ignores the fact that in reality there is another "cost" incurred in trans-

> ferring the property from the donor to the donee; namely, the gift tax, which must be paid in order to make this transfer. As a result, your committee has concluded that to properly reflect total "costs" incurred with respect to donated property it is necessary to increase the basis of the property by the amount of any gift tax paid with respect to it.
>
> As a result, your committee has added a new subsection to the section of present law (sec. 1015) specifying the basis for property acquired by gift. In this new subsection it is provided that the basis of property acquired by gift, after the date of enactment of this bill, is to be increased by the amount of any gift tax paid with respect to the donated property. 1958 U.S. Code Congressional and Administration News, Senate Report, Vol. 3, pg. 4859.

Surely, had Congress viewed the payment of the gift tax as the type of liability, which, if discharged by the donee, would be taxable to the donor as income, it would not have enacted the 1958 amendment specifically telling taxpayers what to do with the gift tax for income tax purposes.

The basis of property acquired by gift is determined under sec. 1015(a) IRC and sec. 1.1015-1(a) Income Tax Reg provides in general that the donee's basis for the purpose of determining gain is the same as the donor's

basis at the time of the gift. Thus the appreciation of the gifted property is taxed upon the donee's disposition of the property. This has been the consistent policy of Congress in the IRC and adoption of the Commissioner's part gift, part sale theory would be in contravention to such intent.

A further indication that the intent of the IRC is not to imply income tax consequences to a gift transfer can be found in sec. 1.1015-4, Income Tax Regs. This section deals with the basis of property acquired in a part gift, part sale transfer, and provides as follows:

> (a) General rule. Where a transfer of property is in part a sale and in part a gift, the unadjusted basis of the property in the hands of the transferee is the sum of
>
> (1) Whichever of the following is the greater:
> (i) The amount paid by the transferee for the property; or
> (ii) The transferor's adjusted basis for the property at the time of the transfer, and
>
> (2) The amount of increase, if any, in basis authorized by section 1015(d) for gift tax paid (see §1.1015-5).

If one were to apply the Commissioner's concept that the amount of the gift tax paid by the donee is the amount of consideration paid by the donee, the basis of the gifted property where the gift tax exceeded the donor's basis would be an amount equal to twice the gift tax paid, since under sec. 1.1015 Income Tax Regs the gift tax represents both the amount paid by the transferee and the amount of the gift tax paid. Adoption of the Commissioner's part gift, part sale theory thus allows the donee to be credited twice with the gift tax. The fact that this type of result can occur indicates once more that the part gift, part sale theory is contrary to the policy of the IRC. It should also be noted, that every example presented in sec. 1.1015-4 Income Tax Regs to illustrate a part gift, part sale involves a sale of property for less than its fair market value, another indication that a net gift was never intended to have the income tax consequences of a part sale, part gift.

It is a well established principle of

law that statutes must be interpreted to reflect the intent of those who drafted them. This principle applies equally to the IRC.

> It is a cardinal principle that in construing a statute the intention of the law-making body should prevail and, if a literal interpretation of a part of a statute operates unjustly or leads to absurd results, or is contrary to the evident meaning of the act taken as a whole, it should be rejected (... authorities cited).
>
> Taxation is a highly practical matter. The revenue act must be construed as a whole, and a sensible construction, one which will effectuate the legislative intention, should be given. The various sections of the act should be so construed that one section will explain and support and not defeat or destroy another section (authorities cited) Brons Hotels, Inc., 34 B.T.A. 376 (1936) at 38..

Further, as part of the Tax Reform Act of 1976, Congress enacted sec. 644 IRC, effective May 21, 1976, which again addressed the income tax consequences of a gift transfer. The impact of sec. 644 IRC is more fully developed at Part D of the Agreement, but once again demonstrates Congress' intent of a separate tax for a separate type of transfer.

The above analysis of the applicable Code provisions establishes that the Commissioner's position disregards the above quoted principle of statutory construction in that the entire structure of the IRC separates gift taxes from income taxes, and mandates that these are separate taxes imposed for separate types of transfers of property. The gift tax is imposed on the transfer of property, and is to be paid as a privilege of such transfer. It may be paid by the donor under sec. 2502(d) IRC or by the donee under sec. 6324(b) IRC, and once paid - regardless by whom - is to only have income tax consequences with respect to the computation of the donee's basis. Congress simply did not provide for it to have any other income tax consequences, just as there are no income tax consequences for the remainderman's interest in estate property to bear the burden of the estate tax for a specific bequest.

The foregoing analysis is the rationale behind the Tax Court's decision in Turner

supra. The Tax Court never got by the threshold question: Is the transfer of property a gift or is it a sale? Once determining that it was a gift transfer, it concluded the IRS's fiction of a part sale was inapposite:

> In all of the above cases, both in a gift tax and income tax context, the major premise of each decision is that a condition imposed by the transferor that the transferee will pay the gift tax resulting therefrom does not alter the result that the transfer constituted a gift. The rationales of the above cases are totally inconsistent with a finding that the transfer was a part sale, part gift. The respective courts in the above cases have, in our opinion, looked at the facts of each case, including the close family relationships involved, and have determined what was in fact intended by the parties. Turner v. Commissioner, supra, 49 T.C. at 362.

C. IN PAYING THE GIFT TAX THE DONEE IS DISCHARGING HIS OWN LIABILITY.

The major premise of the IRS's argument is that the agreement of the donee to pay the gift tax constitutes a shift of the donor's liability to pay the tax under sec. 2502(d) IRC to the donee, and therefore under the teachings of Crane, supra, and Old Colony Trust, supra is recognized as gain for income tax purposes. However, sec. 6324(b) IRC

provides in part:

> Except as otherwise provided in subsection (c), unless the gift tax imposed by chapter 12 is sooner paid in full or becomes unenforceable by reason of lapse of time, such tax shall be a lien upon all gifts made during the period for which the return was filed for 10 years from the date the gifts are made. If the tax is not paid when due, the donee of any gift shall be personally liable for such tax to the extent of the value of such gift.

Clearly, whether the donee specifically agrees to pay the tax or not, he has a significant liability for the gift tax and interest in the tax being paid. The donee may well desire to pay the gift tax to assure himself the lien is extinguished and his personal liability is gone. Neither Diedrich which is before the Court, nor Johnson, supra, relied upon so heavily by the Eighth Circuit in deciding Diedrich, ever considered the donee's liability for the gift tax.

Congress chose to make the donee, as well as the donor, liable for the gift tax because it desired to have the tax imposed upon this type of transfer paid. If the donee pays

this tax liability imposed upon by him by law, it simply should not result in an additional and different taxable event to the donor.

Under sec. 2513 IRC, a spouse who has no interest in the property gifted may join in the gift to reduce the gift taxes payable by reason of the transfer by gift. However, under sec. 2513(d) IRC the spouse who so joins in the gift is jointly and severally liable for the gift tax. Was it Congress' intent to trap the donor into an income tax consequence by authorizing the donor's spouse to assume joint and several liability for the gift tax which would otherwise be the liability of the donor under sec. 2502(d) IRC? To be consistent under the IRS' theory in this case the answer would have to be yes. However, that is clearly not what Congress intended. It intended to permit the spouse to join in the gift so that married couples could reduce the gift taxes imposed by reason of transfer of their spearate property. Further, Congress mandated the tax consequences for the spouse doing so - joint and several liability for the gift tax.

Congress simply never intended any income tax consequences to anyone regardless of who paid the gift tax.

The taxable "release of liabilities" reached under Crane, supra, and Old Colony Trust, supra, have economic reality associated with them. For example, a taxpayer who borrows money by encumbering property in excess of his basis realizes gain in excess of his basis at the time of the borrowing; however the gain is not recognized because borrowing is not a sale or exchange. When the taxpayer transfers the property and is relieved of the encumbrance and liability, he has a permanent economic benefit. There is no obligation imposed by law upon the purchaser of such property that he assume such liability or take the property subject to such liability as a condition of the transfer.

Conversely, in the gift situation, the donee by virtue of sec. 6324(b) IRC, can only receive the transfer subject to the liability for the lien for gift taxes imposed upon such property, and subject to the personal liability for such gift tax to the extent of the

value of such property at the time of the gift. With respect to the gift transfer, the donor has realized zero less his tax basis in the property transferred. The loss of this tax basis to the donor is not recognized by the donor because the nature of the transaction is not a sale or exchange, but rather a gift, and under sec. 1015 IRC the donor's basis in the property is rolled over to the donee to be subsequently taken into account on a sale or exchange by the donee.

In effect, the IRS contends that the donor, who has already realized a non-recognizable loss for his gift transfer should be credited with his basis but saddled with the "release" of the gift tax liability as the amount realized, and that the gain should be recognized because the property is transferred. However, the "liability released" is also the donee's liability and the transfer itself is not a sale or exchange but a gift.

The IRS' argument compares apples to oranges. In effect, the IRS contends the donor cannot make a net gift and end up with

zero; his property is gone, his basis in the property is gone without realizing a loss under sec. 1001 IRC, and he has an income tax liability. This cannot be the result where Congress has said the donee can pay the gift tax.

D. BY NOT CHANGING THE RESULTS OF THE EXISTING CASE LAW WHEN IT ENACTED THE TAX REFORM ACT OF 1976, CONGRESS APPROVED SUCH CASE LAW.

With the passage of the Tax Reform Act of 1976, Congress drastically altered the federal gift and estate tax provisions. Generally, prior to December 31, 1976, there were separate graduated tax rate schedules for gifts and estates. By gifting property, and excepting gifts in contemplation of death, a taxpayer could permanently exclude the value of the gift from his estate. Thus, a taxpayer through a planned gift program could balance the taxes imposed by gift or at death at approximately equal tax rates under the respective graduated schedules. The tax benefit then would be realized at death when the

taxpayer's estate, reduced by the value of prior gifts, would be taxed at lesser rates than if the gifted property had been included in the estate.

Effective January 1, 1977, Congress abolished this system, and established a single tax rate schedule for gifts and estates and phased in the unified credit for both purposes. The effect of this change made it easier for taxpayers to make gifts without incurring an immediate gift tax because of the unified credit, but also made all taxable gifts after December 31, 1976, includible in the gross estate of the donor at the value of the property at the time of the gift; the estate tax is then calculated at the graduated rates including the gifted property, and the taxpayer receives a credit for any gift tax paid. In effect, after December 31, 1976, a taxpayer could only exclude the appreciation of the property after the gift from the estate tax.

In enacting this massive overhaul of the method used to tax gifts, Congress did not alter any of the income tax consequences to

the donee's basis, nor did it change in any way the philosophy of excluding gifts from income and the definition of gift transfer vis-a-vis sale or exchange transfers. It did, however, specifically address one concern it had for the transfer by gift of highly appreciated property to a trust in creating sec. 644 IRC, effective May 21, 1976.

Sec. 644 IRC, in effect, requires the income tax computation for the sale or exchange of property received by a trust, if disposed of within two years of its receipt, to be calculated using the donor's income tax bracket and not the trust's bracket. The abuse sought to be avoided by this section was the escape by the donor from paying income taxes at his rates by gifting property to a trust which would presumably have lower rates:

> The bill, provides a special rule to cover the possible abuse where the grantor places in trust property which has unrealized appreciation in order to shift the payment of tax to the trust at its lower progressive rate structure. Tax Report Act of 1976, P.L. 94-455 pg. 186.

This massive overhaul of the gift tax

provisions with a specific address to the income taxation of highly appreciated property transferred to a trust - the identical type transfer made by the Cleavers - was not enacted in a vacuum. The IRS had advanced its theories to create income tax consequences in gift transfers through the courts for fourteen years.

The specific part sale part gift theory advanced here had been rejected by the Tax Court, and the Fourth, Fifth and Sixth Circuits for eight (8) years prior to Congress' enactment of the Tax Reform Act of 1976. If Congress sought to legislate a result contrary to this impressive precedent, it would have done so as part of the Tax Reform Act of 1976.

As a general rule, this Court has consistently recognized that Congress is presumed to have knowledge of applicable judicial precedent when enacting legislation. In Callanan v. United States, 364 U.S. 587, 594 (1961), this Court noted that "Congress is, after all, not a body of laymen with the commonplace of our law. This legislation was the formulation

of the two Judiciary Committees, all of whom are lawyers, and the Congress is predominantly a lawyers' body."

This Court has consistently held that legislation must be construed in terms of judicial precedent in existence at the time of its enactment. In Shapiro v. United States, 335 U.S. 1, 16 (1948), quoting Hecht v. Malley, 265 U.S. 144, 153 (1924) this Court held that:

> "Moreover, there is a presumption that Congress, in re-enacting the immunity provision of the 1893 Act, was aware of the settled judicial construction of the statutory immunity. In adopting the language used in the earlier act, Congress 'must be considered to have adopted also the construction given by this Court to such language, and made it a part of the enactment.'"

Further, in Exploration Company v. United States, 247 U.S. 435, 449 (1918), this Court held that existing caselaw must be looked to in construing acts of Congress:

> "When Congress passed the act in question the rule of Bailey v. Glover [88 U.S. (21 Wall.) 342 (1874)] was the established doctrine of this court. It was presumably enacted with the ruling of that case in mind. We cannot believe that Congress intended to give immunity to those who for the period

> named in the statute might be able to conceal their fraudulent action from the knowledge of the agents of the Government."

Accord, Canada Packers, Ltd. v. Atchison, Topeka & Santa Fe Ry. Co., 385 U.S. 182 (1966). See also, Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 733 (1975); Allen v. Grand Central Aircraft Co., 347 U.S. 535,544-45 (1954).

Likewise, the Federal Courts of Appeal have held that Congress' enactment of legislation must be construed in light of the then existing caselaw. See generally, Toilet Goods Association v. Finch, 419 F.2d 21 (2d Cir. 1969); Kansas City, Missouri v. Federal Pacific Electric Co.. 310 F.2d 271 (8th Cir.), cert., denied, 371 U.S. 912 (1962); Texaco, Inc. v. Federal Power Commission, 317 F.2d 796 (10th Cir. 1963), rev'd on other grounds, 377 U.S. 33 (1964); Jones v. Goodson, 121 F.2d 176 (10th Cir. 1941); Bovay v. H. M. Byllesby & Co., 88 F.2d 990 (5th Cir. 1937); Knowles v. Gladden, 254 F. Supp. 643 (D. Ore. 1965). The Eighth Circuit held:

> "In searching for the will and intent, it is to be assumed that Congress was

> aware of established rules of law applicable to the subject matter of the statute and thus, upon enactment, the statute is to be read in conjunction with the entire existing body of law." Kansas City, Missouri, supra at 272.

There is clearly a "presumption that Congress was aware of the applicable decisions, and its recognition of them, when it enacted [the act in question]." Texaco, supra at 801.

In the recent decision of Illinois Brick Co. v. Illinois, 431 U.S. 720, 733 n.14 (1977), this Court held that Congress' enactment of the Hart-Scott-Rodins Antitrust Improvements Act of 1976, which permitted the individual states to initiate parens patrial suits on behalf of their citizens, must be read in light of existing caselaw which severely limited the standing of potential plaintiffs. In that instance, the Supreme Court had not previously addressed this specific question of antitrust standing and the Court held that Congress enacted the parens patrial legislation with full knowledge that the federal courts of appeal construed such standing very narrowly.

For eight (8) years prior to the

enactment of the Tax Reform Act of 1976, the existing caselaw consistently rejected the IRS part sale, part gift theory. This is not an instance where only a single isolated court decision is involved. See, e.g., United States v Raynor, Indiana, 302 U.S. 540, 551-52 (1941). Given unanimous judicial precedent of this length, Congress by implication codified this existing caselaw. See, e.g., United States v. Chicago, N.S. & M.R. Co., 288 U.S. 1 (1933) (10 years); United States v. Shreveport Grain & Elevator Co., 287 U.S. 77 (1932) (18 years); Duke Power Co. v. South Carolina Tax Commission, 81 F.2d 513 (4th Cir. 1936) (5 years).

E. TAXPAYERS WERE JUSTIFIED IN RELYING ON THE LONGSTANDING LEGAL PRECEDENT AND THE INTENT OF THE INTERNAL REVENUE CODE REGARDING THE INCOME TAX CONSEQUENCES OF A NET GIFT.

Prior to the Tax Reform Act of 1976, which revamped the gift and estate tax provisions, a common estate planning tool was to gift property in an effort to try to balance the respective graduated tax rates for gifts

and estates. The Congressional action taken in 1976 which adopted a unified tax schedule for gifts and estates spurred many taxpayers, such as the Cleavers, to make substantial gifts prior to the effective date of these changes.

Accordingly, the Cleavers, as many taxpayers, sought counsel for tax planning, and gift programs were designed for their circumstances based on the then existing Internal Revenue Code, treasury regulations, revenue rulings and caselaw. Substantial gifts were made in reliance on the atmosphere of law then existing regarding the tax consequences of net gifts.

The taxpayer contemplating a gift would first look to the IRC and the related treasury regulations to determine the tax consequences of his gift. With respect to transfers of property Congress has enacted separate taxes and provisions in the IRC depending on the nature of the transfer. Therefore, since the transfer contemplated was to be a gift, the applicable tax consequences would be found under the gift tax provisions and applicable

treasury regulations which do not provide for an income tax consequence to the donor regardless of whether or not the donee assumes the gift tax liability. This argument was fully discussed in Part B of the Argument.

After reviewing the applicable IRC provisions and treasury regulations, the cautious taxpayer would examine the pertinent revenue rulings issued by the Service. In the net gift area, the Service had issued several revenue rulings approving the net gift concept. Rev. Rul. 71-232, 1971-1 C.B. 275 as superceded by Rev. Rul. 75-72, 1975-1 C.B. 310, Rev. Rul. 76-57, 1976-1 C.B. 297 and Rev. Rul. 76-104, 1976-1 C.B. 301. For gift tax purposes a net gift is defined as a gift conditioned on the payment of the gift tax by the donee. The net gift value is determined by reducing the gross value of the gift by the amount of the gift tax to be paid by the donee. The above-mentioned revenue rulings contain an elaborate formula to be used for the purpose of arriving at the true tax to be deducted from the value of the gifted property. A reasonable taxpayer

could conclude that this analysis of the tax consequences is the end of the IRS' imposition of tax on his gift transfer. This conclusion would be reinforced by the following sentence found at the end of the above-mentioned revenue rulings: "While the entire transaction is viewed as a gift in part and a sale in part, this Revenue Ruling is concerned only with the gift tax and not with the income tax consequences of the sale." Keeping in mind the caselaw (discussed in Part A of the Argument) existing at the time these revenue rulings were issued, the only logical interpretation of this sentence is that the income tax consequences of the net gift are those which relate to the donee upon his subsequent disposition of the property and the calculation of the donee's basis for purposes of determining gain on such disposition. A taxpayer could certainly conclude if the Service intended the income tax consequences of a net gift to include a taxable gain to the donor,

the Service would simply have stated such.

As the final step in his tax planning, a taxpayer before making a net gift would have reviewed the then existing caselaw. As discussed more fully in Part A of the Argument, by 1976 the Commissioner had presented his position regarding an income tax to a donor of a net gift to the Tax Court, and the Fourth, Fifth and Sixth Circuit Courts and each time his position was rejected. In fact it was not until Diedrich in 1981, many years after the gifts in question were made, that the Commissioner's position was upheld. After a careful review of the state of the law prior to the Eighth Circuit's decision in Diedrich, a taxpayer could only conclude that structuring a gift transaction identical to those found in the caselaw would result in the same tax consequences.

The Eighth Circuit has stated that reliance by Appellants-taxpayers on caselaw precedent is irrelevant since the Eighth Circuit had not decided the issue. While it is true that this is the first opportunity the Eighth

Circuit had to address this issue, it would be ludicrous to suggest that until a given Circuit Court resolves an issue the citizens in that circuit can look to no other jurisdiction, IRC provision, treasury regulations or revenue ruling for guidance in resolving that issue. Were the taxpayers in this appeal and the Cleavers to analyze the law in other jurisdictions, the IRC provisions, the treasury regulations and the revenue rulings to determine the tax consequences of the donee assuming the gift tax liability, they could reach but one conclusion - a net gift results in no income tax consequences to the donor. To ignore this common sense reliance on the state of the law would make effective and intelligent tax planning impossible for taxpayers. The Service and Congress had ample opportunity since 1968, when Turner, supra was decided, to codify the Commissioner's position in this area, but failed to do so. For this Court to act now thirteen years after Turner, supra, would be unfair and inequitable to those taxpayers who made net gifts in reliance on the

state of the law at the time.

III. CONCLUSION.

The facts of the two cases on appeal and of the amicus curaie present a very simple transaction. In each instance the taxpayer-donor gave highly appreciated unencumbered property to a related donee with the only condition being that the donee pay the gift tax liability imposed on the transfer. It is the position of the amicus curaie that there is no question that the transfers were intended by the parties as gifts, and therefore the IRC provisions applicable to gift transfers should be applied.

The Commissioner's position is to take this gift transaction and in addition to the gift tax already imposed, levy a tax based on the premise that the donor receives an economic benefit equal to the gift tax liability paid by the donee since this payment is a discharge of the donor's debt. A discharge of a taxpayer's indebtedness is defined as an item

of gross income under sec. 61(a)(12) IRC; therefore, according to the Commissioner the donor has gross income equal to the gift tax paid by the donee. This reasoning is fallacious since the gift tax liability if not paid can become an economic burden to the donee. Consequently the payment of the gift tax also results in an economic benefit to the donee.

The factual pattern of the gift transactions before the Court is identical to that presented in Turner, supra and clearly distinguishable from Johnson, supra, which was followed by the Eighth Circuit. Both Turner, supra and Johnson, supra are good law and should be applied respectively to similar fact situations. The only decision which should be overruled by this Court is Diedrich which ignores the factual distinctions between Turner, supra and Johnson, supra.

Respectfully Submitted ,

P.O. Address:

Suite 500
611 North Broadway St.
Milwaukee, WI 53202
Phone: (414) 271-2700

By _____
Joseph C. Niebler
Miller and Niebler S.C.